Bloomberg

San Diego`s 'Radical Idea' May Help Cities Slash $382 Billion Pension Gap

By Christopher Palmeri - Dec 3, 2010

Cities from New York to San Jose, California, facing almost $400 billion in unfunded pension liabilities, will be watching what San Diego Mayor Jerry Sanders calls his “radical idea” to cut costs.

After voters in the eighth most-populous U.S. city rejected a half-cent sales tax increase to balance the budget Nov. 2, Sanders is pushing to eliminate pension plans for new city employees, offering 401(k)-like savings accounts instead.

Sanders’s plan, which would replace a pensioner’s certain return with a market-based benefit, exemplifies cities’ struggle to escape the pincers of falling tax revenue and rising retirement costs that consume as much as a fifth of their budgets. The longest recession since the Great Depression cut receipts in 2010 the most in 25 years, the National League of Cities said last month.

“We’re all going to have to get realistic,” Sanders, a 60-year-old Republican, said in a telephone interview. “The private sector went through this. Government will have to relook at how we do stuff as well.”

Stock-market losses left 50 of the largest municipal pension plans with an unfunded gap of $382 billion as of June 2009, according to Joshua Rauh, a professor at Northwestern University’s Kellogg School of Management in Evanston, Illinois. That’s the equivalent of $14,000 per household in those cities, or more than three years of revenue.

“It’s a double whammy,” Rauh said in a telephone interview. “Exactly at the time when tax revenues are down, so are their pension portfolios.”

Opaque Numbers

There are no standardized reporting rules for analyzing municipal retirement costs, said Gary Pollack, who helps oversee $12 billion as head of fixed-income trading at Deutsche Bank AG’s Private Wealth Management unit in New York.

“I’d like to see some uniformity, so you can make comparisons without a magnifying glass,” Pollack said in a telephone interview. “It’s a long-term problem which needs to be addressed.”

What is certain is that the percentage of general-fund spending on retirement benefits has in the past decade more than doubled in some of the largest U.S. cities, leading to cuts in services and jobs.

The problem mirrors that in states, where only half could pay for 80 percent of promised benefits in their 2009 fiscal years, according to data compiled by Bloomberg.

Not for Cops

About 15 states let employees join so-called defined- contribution plans similar to the 401(k), according to the Baton Rouge, Louisiana-based National Association of State Retirement Administrators. Nationally, only 17 percent of public-sector workers are in such plans, versus 41 percent in the private sector, according to the Employee Benefits Research Institute in Washington.

Sanders's defined-contribution plan would apply to civilian employees in the city of 1.3 million. Police and firefighters would not be eligible, because lower benefits might hurt recruiting, he said.

His idea, which he'll ask voters to approve, "will likely be explored by other cities," Christopher Hoene, research director for the Washington-based National League of Cities, said in an e-mail.

Chuck Reed, mayor of San Jose, 460 miles (740 kilometers) north of San Diego, said Sanders inspired him to tackle his city's pension.

"San Diego is the leader, the bleeding edge," he said. "They've been ahead of the rest of us on this."

San Jose, which is America's 10th-most populous city and has 1 million residents, increased payouts to police and firefighters three times in the past 15 years, lifting the maximum benefit to 90 percent of their salary. In 1995, it was 75 percent, according to a September presentation by the mayor.

Boom Times

The changes came as the population of the Silicon Valley municipality climbed 20 percent and housing prices doubled, according to City-Data.com. Benefits enacted when times were good cost dearly, Reed, a 62-year-old Democrat, said in a telephone interview.

"Health-care costs keep going up, but the retirement part was self-inflicted," Reed said. "We thought when we were rich that it would last forever."

Instead, the bills came due.

San Jose voters approved two pension-related measures Nov. 2. One reduces arbitrators' power to determine municipal employee contracts. Another lets the city create a second tier of benefits for new workers, Reed said.

Potholes and Sidewalks

In Los Angeles, pensions and health care will cost more than $800 million or 18 percent of revenue this year, according to City Administrative Officer Miguel Santana. Ten years ago, they cost $164 million or 5.1 percent.

The nation's second-biggest municipality, with nearly 4 million people, has eliminated 3,500 positions and closed libraries two days a week, Santana said. It is making only temporary asphalt repairs to sidewalks and filling one-third fewer potholes, said Lisa Hansen, a city spokeswoman.

New York City will cut 10,000 jobs during the next 18 months. That will help pay for an 18.5 percent increase in pension costs, to $8.3 billion, or 20 percent of projected tax revenue in 2012, according to Marc LaVorgna, a mayoral spokesman. A decade ago, New York's pension costs were 4.8 percent of revenue.

Big Drag

"A 10,000-job reduction represents a significant drag on the economy," said James Parrot, chief economist at the nonpartisan Fiscal Policy Institute in New York. "That's almost half the projected job growth for next year."

Yesterday, New York City's chief actuary, Robert North, joined Mayor Michael Bloomberg and City Comptroller John Liu in predicting that the nation's most populous city will lower the assumed return on its $106.2 billion pension investments from the current 8 percent rate.

The mayor is founder and majority owner of Bloomberg News parent Bloomberg LP.

Pittsburgh's City Council in October rejected Mayor Luke Ravenstahl's proposal to lease parking garages to raise $452 million for pensions, leaving the city of 311,000 to face a state takeover of its plan next year, Joanna Doven, a mayoral spokeswoman, said in a telephone interview.

City pension costs will rise to $127 million from $45 million by 2017, according to a release from the mayor. The plan is 34 percent funded, according to an actuarial report.

Ravenstahl is unwilling to issue "irresponsible new debt" to pay for a continuing expense, she said: "It's just kicking the can down the road."

Courts have ruled that pension benefits for existing employees cannot be removed, San Diego City Attorney Jan Goldsmith said in a telephone interview.

Yanking the Rug

“You can’t promise someone something for 30 years and pull the rug out from under them when they retire,” Michael Zucchet, general manager of the San Diego Municipal Employees Association, said in a telephone interview.

Putting future hires into defined-contribution plans will not reduce current shortfalls, Steven Kreisberg, director of collective bargaining and health-care policy at the Washington- based American Federation of State, County and Municipal Employees, the country’s largest public employee union, said in a telephone interview.

Costs will rise because cities will keep traditional plans operating with fewer members, he said.

“The only way to address underfunding is to fund,” he said.

Sanders said San Diego’s plan will cost less “simply because you’re paying as you go, not racking up this huge deficit.” An actuary will create a savings estimate before an as-yet-unscheduled ballot measure, he said.

‘Enron by the Sea’

San Diego earned the nickname “Enron by the Sea” for a pension-fund scandal that led to the resignation of a previous mayor and half a dozen city officials. The city settled claims by the Securities and Exchange Commission in 2006 that it committed fraud when it failed to make adequate disclosures to investors about a pension fund shortfall.

Sanders, a former police chief elected in 2005, has supported changes to the benefit plans. The city eliminated retiree health coverage for employees hired after 2005. Last year, San Diego reduced its maximum pension payouts and cut in half to 8.75 percent the city’s contribution for new employees.

The defined-contribution plan is unnecessary because the city has already reduced benefits for future hires, said Zucchet, the union head.

“We’ve been cutting for five years,” he said. “We’re five years ahead of the game.”